**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER 04-20050163P**
**TAX ADMINISTRATION—NEGLIGENCE PENALTIES FOR THE USE TAX REPORTING PERIODS COVERING CALENDAR YEARS 2001-03**

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## ISSUE

### I. Tax Administration—Negligence Penalty—Audit Deficiency (Use Tax)

Authority: IC §§ 6-2.5-5-3(b) (1998), 6-8.1-1-1, -5-1(b), -10-2.1 and 10-7 (2004); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257 (Ind. 2002); *Ind. Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); *General Motors Corp. v. Ind. Dep't of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991), *aff'd* 599 N.E.2d 588 (Ind. 1992); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018 (Ind. Tax Ct. 1999); 45 IAC § 2.2-5-8 (2001) and 15-11-2(b) and (c) (2004)

The taxpayer protests the proposed assessment of negligence penalties for its incurring an audit deficiency of use tax.

## STATEMENT OF FACTS

The taxpayer manufactures silicone pellets it supplies to the automotive and appliance industries. It is a foreign corporation, chartered in Delaware and headquartered in a state other than Delaware or Indiana. The Secretary of State authorized the taxpayer to do business in Indiana in December 1986, and it began filing gross retail (sales)/use tax returns (Form ST-103) with this Department in February 1987. During calendar years 2001-03 (hereinafter "the audit period") the taxpayer had one Indiana plant.

The Department conducted a field audit of the taxpayer's sales and use tax liability incurred in operating its Indiana plant during the audit period. The auditors did not adjust the taxpayer's sales tax liability. However, they did make several adjustments increasing its use tax liability after discovering transactions on which the taxpayer had not paid sales tax. The auditors conducted a sample audit of several categories of expensed purchases they discussed in the Audit Summary under the broad overall heading of "Non-manufacturing Equipment and Supplies." Under this heading the auditors increased the taxpayer's use tax liability on expensed purchases of office equipment and supplies and maintenance tools used on production equipment. The auditors also assessed use tax on fifty (50) percent of the purchase prices of the forklifts and the items used to repair them the taxpayer bought during the audit period. They made this adjustment based on a time study the taxpayer had conducted that showed that it used the

forklifts fifty (50) percent of the time in, and fifty (50) percent of the time outside, the production process.

The use tax audit resulted in proposed assessments totaling in the low five-figure range for the audit period. The auditors also proposed, and the Audit Division approved, including a negligence penalty in the Notices of Proposed Assessment for each year of the audit period. The taxpayer paid the parts of the assessments equal to the base tax and accrued interest and timely filed a written protest, but only of the negligence penalties. The Department will provide additional facts as needed.

## DISCUSSION

### A. APPLICABLE PENALTY LAW

IC § 6-8.1-10-2.1 (2004) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person:… (3) [i]ncurs, upon examination by the department, a deficiency that is due to negligence; … the person is subject to a penalty." *Id.* Title 45 IAC § 15-11-2(b) (2004) defines "negligence" in relevant part as follows:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. *Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence.*

*Id.* (Emphasis added.) "[L]isted tax laws" refers to the definition of the term "listed taxes" found in IC § 6-8.1-1-1 (2004). The listed taxes are all of the tax laws for which the General Assembly has explicitly made the Department responsible. They include the Gross Retail and Use Tax Act of 1963, IC article 6-2.5 (1998) (current version at *id.* (2004)) ("GRUTA").

"If a person subject to the penalty imposed under this section [IC § 6-8.1-10-2.1] can show that the failure to…pay the deficiency determined by the department was *due to reasonable cause* and not due to willful neglect, the department shall waive the penalty." IC § 6-8.1-10-2.1(d) (emphasis added.). The implementing regulation restates this requirement as requiring the taxpayer to show that the failure to discharge its tax duties "was due to reasonable cause and not due to negligence." 45 IAC § 15-11-2(c). This subsection of the regulation goes on to state:

> In order to establish reasonable cause, the taxpayer must demonstrate that it exercised *ordinary business care and prudence* in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> …
>
> (2) judicial precedents set by Indiana courts[.]

*Id.* (Emphasis added.) The taxpayer "must make an affirmative showing of all facts alleged as a

reasonable cause for [its] failure to … pay the deficiency[.]" IC § 6-8.1-10-2.1(e). The evidentiary showing the taxpayer must make under IC § 6-8.1-10-2.1(d) and (e) and 45 IAC § 15-11-2(c) is consistent with IC § 6-8.1-5-1(b), which places the burden of proof in all protests on the person against whom a proposed assessment is made to prove that it is wrong.

IC § 6-8.1-10-7 imposes the only other limits, monetary ones, on the Department's authority to assess and enforce a penalty under IC § 6-8.1-10-2.1. That statute provides:

> Notwithstanding the various penalty provisions of [IC] chapter [6-8.1-10], the maximum total penalty that may be assessed against a person under sections 2.1 through 5 of this chapter [i.e., IC §§ 6-8.1-10-2.1 to -5, which all use percentage formulas to calculate the respective penalties they impose] is one hundred percent (100%) of the unpaid tax and *the minimum penalty, if any, that may be assessed under those sections is five dollars ($ 5).*

*Id.* (Emphasis added).

## B. TAXPAYER'S ARGUMENT

The taxpayer argues that the purchases giving rise to the deficiency represented only a small percentage of its total purchases for the audit period. The taxpayer is essentially contending that the Department should waive the negligence penalties because the percentage of purchases on which it failed to pay use tax is, in the taxpayer's view, *de minimis*.

## C. ANALYSIS

As noted at the end of Subpart A, IC § 6-8.1-10-7 sets the maximum and minimum amounts of percentage-based penalties, including the negligence penalty, the Department may assess; the minimum is five dollars ($5). However, once the Department has assessed a negligence penalty over that minimum, as it did here, IC § 6-8.1-10-2.1(d) or (e) govern the Department's ability to waive that penalty. There is nothing in either of those subsections that even authorizes the Department to waive a negligence penalty on the ground that the amount of unpaid tax is *de minimis*, much less anything setting out an amount, or a formula to determine an amount, of unpaid tax that the Department could treat as being *de minimis*. Nor does IC § 6-8.1-5-1(a), the subsection requiring the Department to make a proposed assessment of tax it reasonably believes was not properly reported, set any minimum figure of unpaid tax below which the Department is excused from doing so. Had the General Assembly wanted to set a floor amount of unpaid tax below which it would deem the taxpayer not liable for any such tax as a matter of law, it easily could have said so.

The only ground on which IC § 6-8.1-10-2.1(d) requires the Department to waive a negligence penalty, once assessed, is "reasonable cause[.]" *Id.* The legislature's use of this term necessarily implies that the determinative factor for the Department in deciding whether to waive a negligence penalty is the cause of, not the amount of unpaid tax resulting from, the compliance failure in question. The only material reference to a number concerning the negligence penalties IC § 6-8.1-10-2.1(a) imposes is to the amount of unpaid, underpaid, unreported or underreported taxes. The only use for that figure that IC § 6-8.1-10-2.1 mentions is to compute the negligence penalty; subsection (b) uses that amount as the multiplicand to which the Department applies the ten percent multiplier to determine the amount of the subsection (a) penalty. *See* IC § 6-8.1-10-

2.1(b) (setting out the computation formulae). The size of this multiplicand, standing alone, is irrelevant to answering the questions of why and how it came into being, and more precisely to answering the question of whether or not the failure out of which it arose was due to the taxpayer's negligence.

The taxpayer has not made any alternative argument, much less submitted any evidence in support of such an argument, as to why its "failure to…pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect[.]" IC § 6-8.1-10-2.1(d). Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule later in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review],…administrative agenc[ies] that already bear[ ]…difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25. The Department will therefore base its determination of the presence or absence of reasonable cause for the taxpayer's incurring its use tax deficiency solely on the evidence and information in the audit file.

In its protest letter the taxpayer alleged it had consumed or otherwise used items (e.g., labels for intermediates, thermal ribbons and strapping tools) in certain categories of expensed purchases in its manufacturing process. The taxpayer further stated that for this reason, it had been under the impression that purchases in those categories had been tax-exempt. However, the taxpayer has not protested the substantive assessments of base use tax on those purchase categories.

As it turned out, the taxpayer made one or more mistakes of fact regarding the scope of its production process, and by extension one or more mistakes of law as to the extent it was entitled to treat its expensed purchases as being for exempt uses in that process. The auditors made all of the adjustments under the heading "Non-manufacturing Equipment and Supplies" under the authority of 45 IAC § 2.2-5-8, the regulation that interprets and implements IC § 6-2.5-5-3(b). This latter subsection of GRUTA exempts from sales and use tax "manufacturing machinery, tools, and equipment…if…acquire[d]…for direct use in the direct production…of other tangible personal property." *Id.*

The taxpayer has been doing business in Indiana continuously for over 19 years and has been subject to GRUTA for all of those years. The General Assembly enacted IC § 6-2.5-5-3 as part of its recodifications of GRUTA in 1980. The Department promulgated 45 IAC article 2.2, including 45 IAC § 2.2-5-8, on December 1, 1982. LSA Doc. #82-86(F), 6 I.R. 8 (Jan. 1, 1983)

(codified as amended at *id.* (2001)) (current version at *id.* (2004)). Both the statute and the regulation thus have been in effect for the entire time since the taxpayer began doing business in this state in late 1986 and began filing sales and use tax returns in early 1987. The taxpayer is charged with constructive knowledge of both of these authorities and of the judicial opinions of the Indiana courts interpreting this exemption. *E.g.*, *Ind. Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983) and *General Motors Corp. v. Ind. Dep't of State Revenue*, 578 N.E.2d 399, 401-05 (Ind. Tax Ct. 1991), *aff'd* 599 N.E.2d 588, 588-89 (Ind. 1992). It should have been well aware by the years of the audit period of both the scope of its production process and whether and to what extent these authorities would permit it to exempt manufacturing machinery, tools and equipment as being used in that process. However, if it was in any doubt and needed guidance, it could have referred to, or obtained competent professional advice on, these authorities.

The taxpayer did not know about, knew about but misunderstood and misapplied, or ignored the law governing this exemption. The Department infers this lack of "ordinary business care and prudence," 45 IAC § 15-11-2(c), from three facts. First, the taxpayer was in fact aware of the scope of its production process, as evidenced by the study it conducted of its exempt and taxable percentages of use of its forklifts and the items it bought to repair them. Second, notwithstanding this awareness, the taxpayer incurred a use tax audit deficiency, part of which was on its expensed purchases. Third and last, the taxpayer failed to protest this part of the total deficiency on substantive grounds. The taxpayer thereby has tacitly admitted that it did not apply, or incorrectly applied, these authorities in failing to self-assess and remit use tax on the non-exempt part of its expensed purchases during the audit period.

The Department therefore finds that the audit adjustments to those purchases summarized in the Statement of Facts did not occur despite the exercise of "ordinary business care and prudence[,]" *id.*, and thus were not "due to reasonable cause[.]" IC § 6-8.1-10-2.1(d). Rather, they are evidence of either "carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code [and] department regulations[,]" "[i]gnorance of the listed tax laws, rules and/or regulations[,]" or both. 45 IAC § 15-11-2(b). As such, the foregoing failures constituted "negligence" as 45 IAC § 15-11-2(b) defines that word. Accordingly, the Department further finds that the taxpayer was negligent and the Audit Division properly proposed assessing the negligence penalties.

## FINDING

The taxpayer's protest is denied.

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